

Multiple Choice Questions

1. A single, overall cost of capital is often used to evaluate projects because:
 - a. **It avoids the problem of computing the required rate of return for each investment proposal.**
 - b. It is the only way to measure a firm's required return.
 - c. It acknowledges that most new investment projects have about the same degree of risk.
 - d. It acknowledges that most new investment projects offer about the same expected return.

2. The weighted average cost of capital for a firm is the:
 - a. Discount rate which the firm should apply to all of the projects it undertakes.
 - b. **Rate of return a firm must earn on its existing assets to maintain the current value of its stock.**
 - c. Coupon rate the firm should expect to pay on its next bond issue.
 - d. Maximum rate which the firm should require on any projects it undertakes.
 - e. Required rate which every project's internal rate of return must exceed.

3. Peter's Audio Shop has a cost of debt of 7%, a cost of equity of 11%, and a cost of preferred stock of 8%. The firm has 104,000 shares of common stock outstanding at a market price of \$20 a share. There are 40,000 shares of preferred stock outstanding at a market price of \$34 a share. The bond issue has a total face value of \$500,000 and sells at 102% of face value. The tax rate is 34%. What is the weighted average cost of capital for Peter's Audio Shop?
 - a. 6.14%
 - b. 6.54%
 - c. 8.60%
 - d. **9.14%**
 - e. 9.45%

4. If the CAPM is used to estimate the cost of equity capital, the expected excess market return is equal to the:
 - a. Return on the stock minus the risk-free rate.
 - b. Difference between the return on the market and the risk-free rate.**
 - c. Beta times the market risk premium.
 - d. Beta times the risk-free rate.
 - e. Market rate of return.

5. The best fit line of a pair wise plot of the returns of the security against the market index returns is called the:
 - a. Security Market Line.
 - b. Capital Market Line.
 - c. Characteristic line.**
 - d. Risk line.
 - e. None of the above.

6. The weighted average cost of capital for a firm is the:
 - a. Discount rate which the firm should apply to all of the projects it undertakes.
 - b. Overall rate which the firm must earn on its existing assets to maintain the value of its stock.**
 - c. Rate the firm should expect to pay on its next bond issue.
 - d. Maximum rate which the firm should require on any projects it undertakes.
 - e. Rate of return that the firm's preferred stockholders should expect to earn over the long term.

7. Using the CAPM to calculate the cost of capital for a risky project assumes that:
 - a. using the firm's beta is the same measure of risk as the project.
 - b. the firm is all-equity financed.
 - c. the financial risk is equal to business risk.

- d. Both A and B.**
e. Both A and C.
8. If the project beta and IRR coordinates plot above the SML the project should be:
a. accepted.
b. rejected.
c. It is impossible to tell.
d. It will depend on the NPV.
e. None of the above.
9. Beta measures depend highly on the:
a. direction of the market variance.
b. overall cycle of the market.
c. variance of the market and asset, but not their co-movement.
d. covariance of the security with the market and how they are correlated.
e. All of the above.
10. The formula for calculating beta is given by the dividing the _____ of the stock with the market portfolio by the _____ of the market portfolio.
a. variance; covariance
b. covariance; variance
c. standard deviation; variance
d. expected return; variance
e. expected return; covariance
11. The slope of the characteristic line is the estimated:
a. intercept.
b. beta.
c. unsystematic risk.
d. market variance.
e. market risk premium

12. Betas may vary substantially across an industry. The decision to use the industry or firm beta: to estimate the cost of capital depends on
- a. how small the estimation errors are of all betas across industries.
 - b. how similar the firm's operations are to the operations of all other firms in the industry.**
 - c. whether the company is a leader or follower.
 - d. the size of the company's public float.
 - e. None of the above.
13. Comparing two otherwise equal firms, the beta of the common stock of a levered firm is _____ than the beta of the common stock of an unlevered firm.
- a. equal to
 - b. significantly less
 - c. slightly less
 - d. greater**
 - e. None of the above.
14. A firm with high operating leverage has:
- a. low fixed costs in its production process.
 - b. high variable costs in its production process.
 - c. high fixed costs in its production process.**
 - d. high price per unit.
 - e. low price per unit
15. If a firm has low fixed costs relative to all other firms in the same industry, a large change in sales volume (either up or down) would have:
- a. a smaller change in EBIT for the firm versus the other firms.**
 - b. no effect in any way on the firms as volume does not effect fixed costs.
 - c. a decreasing effect on the cyclical nature of the business.
 - d. a larger change in EBIT for the firm versus the other firms.
 - e. None of the above.

16. A firm with high operating leverage is characterized by _____ while one with high financial leverage is characterized by _____.
- a. low fixed cost of production; low fixed financial costs
 - b. high variable cost of production; high variable financial costs
 - c. high fixed costs of production; high fixed financial costs**
 - d. low costs of production; high fixed financial costs
 - e. high fixed costs of production; low variable financial costs
17. Which one of the following statements is correct concerning the weighted average cost of capital (WACC)?
- a. The WACC may decrease as a firm's debt-equity ratio increases.**
 - b. When computing the WACC, the weight assigned to the preferred stock is based on the coupon rate multiplied by the par value of the stock.
 - c. A firm's WACC will decrease as the corporate tax rate decreases.
 - d. The weight of the common stock used in the computation of the WACC is based on the number of shares outstanding multiplied by the book value per share.
 - e. The WACC will remain constant unless a firm retires some of its debt.
18. Flotation costs should:
- a) Be ignored when analyzing a project because flotation costs are not an actual cost of the project.
 - b) Be averaged over the life of the project thereby reducing the cash flows for each year of the project.
 - c) Only be considered when two projects have the same net present value.
 - d) Be included in the initial cost of a project before the net present value of the project is computed.**
 - e) Be ignored totally when internal equity funding is utilized.

19. Cameron Industries is expected to pay an annual dividend of \$1.30 a share next month. The market price of the stock is \$24.80 and the growth rate is 3 percent. What is the firm's cost of equity?
- a. 7.58 percent
 - b. 7.91 percent
 - C. 8.24 percent**
 - d. 8.40 percent
 - e. 8.76 percent
20. Ellie's Boutique has a bond issue outstanding that matures in fourteen years. The bonds pay interest semi-annually. Currently, the bonds are quoted at 98 percent of face value and carry an 8 percent coupon. The firm's tax rate is 35 percent. What is the firm's after tax cost of debt?
- a) 2.88 percent
 - b) B. 5.36 percent**
 - c) 5.45 percent
 - d) 8.24 percent
 - e) 10.72 percent
21. The Sealing Company has 1,500 bonds outstanding that are selling for \$1,060 each. The company also has 5,000 shares of preferred stock at a market price of \$32 each. The common stock is priced at \$26 a share and there are 36,000 shares outstanding. What is the weight of the common stock as it relates to the firm's weighted average cost of capital?
- a) 6 percent
 - b) 35 percent**
 - c) 41 percent
 - d) 54 percent
 - e) 60 percent
22. The cost of equity capital is all of the following EXCEPT:

- a. The minimum rate that a firm should earn on the equity-financed part of an investment.
 - b. A return on the equity-financed portion of an investment that, at worst, leaves the market price of the stock unchanged.
 - c. By far the most difficult component cost to estimate.
 - d. Generally lower than the before-tax cost of debt.**
23. In calculating the proportional amount of equity financing employed by a firm, we should Use:
- a. The common stock equity account on the firm's balance sheet.
 - b. The sum of common stock and preferred stock on the balance sheet.
 - c. The book value of the firm.
 - d. The current market price per share of common stock times the number of shares outstanding.**
24. To compute the required rate of return for equity in a company using the CAPM, it is necessary to know all of the following EXCEPT:
- a. The risk-free rate.
 - b. The beta for the firm.
 - c. The earnings for the next time period.**
 - d. The market return expected for the time period.
25. In calculating the costs of the individual components of a firm's financing, the corporate tax rate is important to which of the following component cost formulas?
- a. Common stock.
 - b. Debt.**
 - c. Preferred stock.
 - d. None of the above.
26. The common stock of a company must provide a higher expected return than the debt of the same company because

- a. There is less demand for stock than for bonds.
 - b. There is greater demand for stock than for bonds.
 - c. **There is more systematic risk involved for the common stock.**
 - d. There is a market premium required for bonds.
27. A quick approximation of the typical firm's cost of equity may be calculated by
- a. **Adding a 5 percent risk premium to the firm's before-tax cost of debt.**
 - b. Adding a 5 percent risk premium to the firm's after-tax cost of debt.
 - c. Subtracting a 5 percent risk discount from the firm's before-tax cost of debt.
 - d. Subtracting a 5 percent risk discount from the firm's after-tax cost of debt.
28. Market values are often used in computing the weighted average cost of capital because
- a. This is the simplest way to do the calculation.
 - b. **This is consistent with the goal of maximizing shareholder value.**
 - c. This is required in the U.S. by the Securities and Exchange Commission.
 - d. This is a very common mistake.
29. For an all-equity financed firm, a project whose expected rate of return plots should be rejected.
- a. Above the characteristic line
 - b. Above the security market line
 - c. **Below the security market line**
 - d. Below the characteristic line
30. Some projects that a firm accepts will undoubtedly result in zero or negative returns. In light of this fact, it is best if the firm
- a. Adjusts its hurdle rate (i.e., cost of capital) upward to compensate for this fact.
 - b. Adjusts its hurdle rate (i.e., cost of capital) downward to compensate for this fact.
 - c. **Does not adjust its hurdle rate up or down regardless of this fact.**
 - d. Raises its prices to compensate for this fact.

31. The Tchotchke Knick-Knack Company relies on preferred stock, bonds, and common stock for its long-term financing. Rank in ascending order (i.e., 1 = lowest, while 3 = highest) the likely after-tax component costs of the Tchotchke Company's long-term financing.
- 1 = bonds; 2 = common stock; 3 = preferred stock.
 - 1 = bonds; 2 = preferred stock; 3 = common stock.**
 - 1 = common stock; 2 = preferred stock; 3 = bonds.
 - 1 = preferred stock; 2 = common stock; 3 = bonds.
32. Lei-Feng, Inc.'s \$100 par value preferred stock just paid its \$10 per share annual dividend. The preferred stock has a current market price of \$96 a share. The firm's marginal tax rate (combined federal and state) is 40 percent, and the firm plans to maintain its current capital structure relationship into the future. The component cost of preferred stock to Lei-Feng, Inc. would be closest to _____.
- 6 percent
 - 6.25 percent $10/96 = .1042$, remember dividends are not a tax deductible expense, so we don't multiply 10 by one minus the tax rate before continuing our calculation
 - 10 percent
 - 10.4 percent**
33. David Ding is evaluating two conventional, independent capital budgeting projects (X and Y) by making use of the risk-adjusted discount rate (RADR) method of analysis. Projects X and Y have internal rates of return of 16 percent and 12 percent, respectively. The RADR appropriate to Project X is 18 percent, while Project Y's RADR is only 10 percent. The company's overall, weighted-average cost of capital is 14 percent. David should _____.
- Accept Project X and accept Project Y.
 - Accept Project X and reject Project Y. [IRR of pro X(16%) is less than RADR (18%)so, reject the IRR of pro Y is greater than RADR(10%)so accept]
 - Reject Project X and accept Project Y.**
 - Reject Project X and reject Project Y.

34. The term "capital structure" refers to:
- Long-term debt, preferred stock, and common stock equity.**
 - Current assets and current liabilities.
 - Total assets minus liabilities.
 - Shareholders' equity.
35. A critical assumption of the net operating income (NOI) approach to valuation is:
- That debt and equity levels remain unchanged.
 - That dividends increase at a constant rate.
 - That k_0 remains constant regardless of changes in leverage.**
 - That interest expense and taxes are included in the calculation.
36. The traditional approach towards the valuation of a company assumes:
- That the overall capitalization rate holds constant with changes in financial leverage.
 - That there is an optimum capital structure.**
 - That total risk is not altered by changes in the capital structure.
 - That markets are perfect.
37. Two firms that are virtually identical except for their capital structure are selling in the market at different values. According to M&M
- One will be at greater risk of bankruptcy.
 - The firm with greater financial leverage will have the higher value.
 - This proves that markets cannot be efficient.
 - This will not continue because arbitrage will eventually cause the firms to sell at the same value.**
38. The cost of capital for a firm -- when we allow for taxes, bankruptcy, and agency costs --
- Remains constant with increasing levels of financial leverage.
 - First declines and then ultimately rises with increasing levels of financial leverage.**
 - Increases with increasing levels of financial leverage.

- d. Decreases with increasing levels of financial leverage.
39. A firm's degree of operating leverage (DOL) depends primarily upon its
- a. Sales variability.
 - b. Level of fixed operating costs.
 - c. **Closeness to its operating break-even point.**
 - d. Debt-to-equity ratio.
40. An EBIT-EPS indifference analysis chart is used for
- a. Evaluating the effects of business risk on EPS.
 - b. **Examining EPS results for alternative financing plans at varying EBIT levels.**
 - c. Determining the impact of a change in sales on EBIT.
 - d. Showing the changes in EPS quality over time.
41. EBIT is usually the same thing as:
- a. Funds provided by operations.
 - b. Earnings before taxes.
 - c. Net income.
 - d. **Operating profit.**
42. In the context of operating leverage break-even analysis, if selling price per unit rises and all other variables remain constant, the operating break-even point in units will:
- a. **Fall.**
 - b. Rise.
 - c. Stay the same.
 - d. Still be indeterminate until interest and preferred dividends paid are known.
43. If a firm has a DOL of 5 at Q units, this tells us that:
- a. If sales rise by 5%, EBIT will rise by 5%.
 - b. If sales rise by 1%, EBIT will rise by 1%.
 - c. If sales rise by 5%, EBIT will fall by 25%.

d. If sales rise by 1%, EBIT will rise by 5%.

44. This statistic can be used as a quantitative measure of relative "financial risk."

- a. Coefficient of variation of earnings per share (CV_{EPS})
- b. Coefficient of variation of operating income (CV_{EBIT})
- c. ($CV_{EPS} - CV_{EBIT}$)**
- d. ($CV_{EPS} + CV_{EBIT}$)

45. A firm's degree of total leverage (DTL) is equal to its degree of operating leverage its degree of financial leverage (DFL).

- a. Plus
- b. Minus
- c. Divided by
- d. Multiplied by**

46. The further a firm operates above its operating break-even point, the closer its degree of operating leverage (DOL) measure approaches

- a. Minus one.
- b. Zero.
- c. One.**
- d. Infinity.

47. QWC Ltd. has cash of \$100,000 that will be invested in an equity investment that has a beta of 2.25. The current risk-free rate in the market is 2.5%, and the market requires an 8% risk premium for equity securities. What return should QWC Ltd. expect to earn?

- a) \$8,000
- b) \$18,000
- c) \$23,625
- d) \$20,500**

47. XYZ company recently issued rights to raise financing. The shares are currently trading for \$18 per share on the stock exchange. The subscription price for the rights offering is \$14 per share, and an investor will require 3 rights to purchase 1 share. The value of one right is
- a) \$12.00.
 - b) \$2.33.
 - c) \$1.00.**
 - d) \$0.
48. LPY Ltd. has cash of \$500,000 that will be used to create an investment portfolio. The portfolio will be invested evenly in two assets: an equity investment that has a beta of 1.70 and a one-year risk-free interest bearing certificate. The current risk-free rate in the market is 3% and the market requires a 6% risk premium for equity securities. What one-year return should LPY Ltd. expect to earn on its portfolio?
- a) \$7,500
 - b) \$30,000
 - c) \$33,000
 - d) \$40,500**
49. According to the Efficient Market Hypothesis, what effect would a higher-than expected earnings report have on a firm's share price?
- a) A gradual increase in the share price over several days.
 - b) An immediate decrease in the share price, with no later adjustments.
 - c) An immediate increase in the share price, followed by a decrease the following day.
 - d) An immediate increase in the share price, with no later adjustments.**
50. The Capital Asset Pricing Model (CAPM) disregards diversifiable risk because the model
- a) Assumes that investors are risk neutral but not risk averse.
 - b) Assumes that investors will be holding anywhere from one security to the entire market of securities.

- c) Assumes that diversifiable risk represents that aspect of financial risk which is unique to that security and not related to the financial risk of the market.
- d) Recognizes that diversifiable risk can be virtually eliminated with a large enough portfolios.**

51. An asset's market (systematic) risk is measured by its

- a) Variance of returns.
- b) Beta coefficient.**
- c) Standard deviation.
- d) Total return.

52. DHC Ltd. is looking to purchase WIC Ltd., which has the following information:

Revenue	LKR 4,000,000
EBITD	LKR 900,000
Basic EPS	LKR 1.40
Net assets	LKR 5,000,000
Dividends paid	LKR 0.50

Research has shown that the price-earnings ratio for companies like WIC Ltd. is 9.5.

Based on that ratio, what is the value of WIC Ltd.?

- a) \$2,375,000
- b) \$8,550,000
- c) \$5,000,000
- d) \$6,650,000**

53. XYZ Ltd. has the following current and projected information:

	Current	Projected
Sales	LKR 700,000	LKR 800,000
Variable costs (35% of sales)	LKR 245,000	LKR 280,000
Fixed costs (excluding interest and taxes)	LKR 120,000	LKR 120,000
Earnings per share	LKR 0.90	LKR 1.00

Given the above information, what is the projected degree of operating leverage for

XYZ Ltd.?

- a) 0.78
- b) 0.57
- c) 0.74
- d) 1.36**

54. Trout Ltd. produces a single product that has a contribution margin of 60% per unit and sold 500,000 units last year. Trout has a degree of operating leverage of 1.60 and a degree of financial leverage of 1.20 for the current year. If the sales volume were to increase by 10% this coming year, what would be the expected percentage increase in earnings per share (rounded to the nearest percent)?

- a) 16%
- b) 12%
- c) 6%
- d) 19%**

55. SCC Inc. has the following financial information:

Current liabilities	\$900,000
Long-term debt	\$1,300,000
Total liabilities	\$2,200,000
Preferred shares	\$3,500,000
Common equity	\$6,200,000

The long-term debt consists of a single bond issue paying 6% interest annually. These bonds currently yield 7.5% in the market. The current cost of the preferred shares is 8%. The current cost of the common shares is 12%. The company's tax rate is 40%. What is SCC Inc.'s weighted average cost of capital (rounded to the nearest tenth of a percent)?

- a) 9.4%
- b) 10.2%
- c) 9.8%**
- d) 9.2%

56. Flower Inc. is issuing preferred shares to raise capital. Each preferred share will be issued with a par value of \$200 and a cumulative dividend of \$18. The preferred shares will result in after-tax underwriting expenses of \$3 per share. What is the cost of issuing the preferred shares?
- a) **9.14%**
 - b) 9.00%
 - c) 7.50%
 - d) 10.50%
57. Retained earnings are
- a) An indication of a company's liquidity.
 - b) The same as cash in the bank.
 - c) Not important when determining dividends.
 - d) **The cumulative earnings of the company after dividends.**
58. Which of the following is an argument for the relevance of dividends?
- a) Informational content.
 - b) Reduction of uncertainty.
 - c) Some investors' preference for current income.
 - d) **All of the above.**
59. If Ian O'Connor Enterprises, Inc., repurchased 50 percent of its outstanding common stock from the open (secondary) market, the result would be;
- a) A decline in EPS.
 - b) An increase in cash.
 - c) **A decrease in total assets.**
 - d) An increase in the number of stockholders.
60. Company Q is all equity financed. For each £1 of earnings, it consistently pays 30p in dividends and retains 70p for reinvestment. It expects to earn a rate of return of 14% on capital employed. According to the Gordon Growth Model, what would the rate of earnings growth be in future? Ignore tax.

- a) 4.2%
- b) 7%
- c) 9.8%
- d) 14%

61. The dividend-payout ratio is equal to

- a) The dividend yield plus the capital gains yield.
- b) Dividends per share divided by earnings per share.**
- c) Dividends per share divided by par value per share.
- d) Dividends per share divided by current price per share.

62. This type of risk is avoidable through proper diversification.

- a) Portfolio risk
- b) Systematic risk
- c) Unsystematic risk**
- d) Total risk

63. A statistical measure of the degree to which two variables (e.g., securities' returns) move together.

- a) Coefficient of variation**
- b) Variance**
- c) Covariance**
- d) Certainty equivalent**

3. The index model has been estimated for stocks A and B with the following results:

$$R_A = 0.01 + 0.5R_M + e_A$$

$$R_B = 0.02 + 1.3R_M + e_B$$

$$\sigma_M = 0.25 \quad \sigma(e_A) = 0.20 \quad \sigma(e_B) = 0.10$$

The covariance between the returns on stocks A and B is _____.

- a) 0.0384
- b) 0.0406**

- c) 0.1920
- d) 0.0050
- e) 0.4000

4. Consider the single-index model. The alpha of a stock is 0%. The return on the market index is 16%. The risk-free rate of return is 5%. The stock earns a return that exceeds the risk-free rate by 11% although there are no firm-specific events affecting the stock performance. The β of the stock is _____.

- a) 0.67
- b) 0.75
- c) 1.0**
- d) 1.33
- e) 1.50

5. Given the following two stocks A and B

	<u>Expected rate of return</u>	<u>Beta</u>
A	0.12	1.2
B	0.14	1.8

If the expected market rate of return is 0.09 and the risk-free rate is 0.05, which security would be considered the better buy and why?

- a) A because it offers an expected excess return of 1.2%.
- b) B because it offers an expected excess return of 1.8%.
- c) A because it offers an expected excess return of 2.2%.**
- d) B because it offers an expected return of 14%.
- e) B because it has a higher beta.

6. A line that describes the relationship between an individual security's returns and returns on the market portfolio.

- a) Characteristic line**

- b) Security market line
- c) Capital market line
- d) Beta

7. According to the capital-asset pricing model (CAPM), a security's expected (required) return is equal to the risk-free rate plus a premium

- a) **Equal to the security's beta.**
- b) Based on the unsystematic risk of the security.
- c) Based on the total risk of the security.
- d) Based on the systematic risk of the security.

8. The risk-free security has a beta equal to, while the market portfolio's beta equal to

- a) One; more than one.
- b) One; less than one.
- c) **Zero; one.**
- d) Less than zero; more than zero.

9. Beta is the slope of

- a) The security market line.
- b) The capital market line.
- c) **A characteristic line.**
- d) The CAPM.

10. A measure of "risk per unit of expected return."

- a) Standard deviation
- b) **Coefficient of variation**
- c) Correlation coefficient
- d) Beta

11. The greater the beta, the.....of the security involved.

- a) **Greater the unavoidable risk**
 - b) Greater the avoidable risk
 - c) Less the unavoidable risk
 - d) Less the avoidable risk
12. Plaid Pants, Inc. common stock has a beta of 0.90, while Acme Dynamite Company common stock has a beta of 1.80. The expected return on the market is 10 percent, and the risk-free rate is 6 percent. According to the capital-asset pricing model (CAPM) and making use of the information above, the required return on Plaid Pants' common stock should be _____, and the required return on Acme's common stock should be _____.
- a) 3.6 percent; 7.2 percent
 - b) **9.6 percent; 13.2 percent** [plaid required return= $0.06 + [(0.90)(0.10 - 0.06)] = 0.096$]
 - c) 9.0 percent; 18.0 percent acme required return= $0.06 + [(1.8)(0.10 - 0.06)] = 0.132$
 - d) 14.0 percent; 23.0 percent
13. Espinosa Coffee & Trading, Inc.'s common stock measured beta is calculated to be 0.75. The market beta is, of course, 1.00 and the beta of the industry of which the company is a part is 1.10. If Merrill Lynch were to calculate an "adjusted beta" for Espinosa's common stock, that adjusted beta would most likely be _____.
- a) Less than 0.75
 - b) **More than 0.75, but less than 1.10**
 - c) Equal to 1.10
 - d) Equal to 0.95 {i.e., $(1/3) \times (0.75 + 1.00 + 1.10)$ }
14. Which of the following factors is most likely to explain why a company decides to increase its annual dividend?
- a) A firm belief by management that dividends represent a residual payment
 - b) A large number of desirable projects.
 - c) **A large proportion of its shares are owned by institutional investors**
 - d) Pecking order theory
 - e) Poor cash flows

15. If d_1 represents the dividend paid to shareholders, P_0 represents the cum dividend share price and P_1 represents the ex dividend share price, which of the following equations illustrates that dividends are irrelevant to shareholder wealth?
- a) $d_1 + P_1 < P_0$
 - b) $d_1 + P_0 = P_1$
 - c) $d_1 + P_1 > P_0$
 - d) $d_1 + P_1 = P_0$
 - e) $P_0 - P_1 > d_1$
16. Which of the following statements lends most support to the theory that dividend payments are irrelevant to the value of ordinary shares?
- a) Shareholders making homemade dividends face dealing costs
 - b) Shareholders are concerned with total earnings rather than with the split between distributed and retained earnings.
 - c) **Investors' discount rates increase with time due to uncertainty.**
 - d) Firms have particular clienteles due to their dividend policy
 - e) Investors tend to prefer speedy growth in annual dividends
17. Which of the following statements is consistent with dividend irrelevance theory?
- a) **Investment decisions are the sole determinant of shareholder wealth**
 - b) Making homemade dividends causes investors to incur transaction costs
 - c) Companies with stable dividend policies build up shareholder clienteles
 - d) Investors like to maintain the real value of their dividend payments.
 - e) Institutional investors like to match regular payments with regular income
18. Which of the following statements lends support to the theory that dividend payments are relevant to the value of ordinary shares?
- a) Investment policy is the only wealth-creating decision made by managers
 - b) **Firms establish shareholder clienteles due to their dividend policy**
 - c) Shareholders can make homemade dividends by selling shares

- d) Dividends represent a residual payment to shareholders
- e) Shareholders are concerned with total earnings rather than with the split between distributed and retained earnings.

19. An investor is looking to calculate the current share price of Bolder plc. Given the risk of the company the investor requires an annual return of 13 percent. The company's share price is still cum div and the current dividend (to be paid shortly) is 23p per share. Historically, dividends have grown at an annual rate of 8 percent. What is the company's current share price?

- a) £4.83
- b) £4.60
- c) £4.74
- d) £5.20**
- e) £4.97

20. The current ex div market price of a share is £2.25p and the current dividend (just paid) was 20p. Shareholders require a return from the share of 16 percent. What is the dividend growth rate expected by shareholders?

- a) 6.5 percent.**
- b) 8.7 percent.
- c) 6.9 percent.
- d) 7.8 percent.
- e) 7.1 percent.

21. Close Range plc's current ex div share price is 250p and the company has been paying a constant annual dividend of 30p per share for the past 10 years. The company is planning to suspend payment of dividends for the next two years in order to invest in a new project. It will pay an increased cash dividend of 40p per share per year from the end of year 3, with dividends continuing at this level for the foreseeable future. What is the increase in wealth for shareholders arising from the new project?

- a) No change in wealth.

- b) -9p per share.
- c) +10p per share.
- d) +16p per share.**
- e) -13p per share.

22. XYZ's current cum div share price is £3.45 and the company has just announced a dividend of 20p per share. At what rate do investors expect its dividends to grow in the future, if the current share price is thought to be a fair one and if investors require a rate of return of 15 percent?

- a) 8.3 percent.**
- b) 7.8 percent.
- c) 9.5 percent.
- d) 7.1 percent.
- e) 8.9 percent.

23. Terracotta plc has paid an annual dividend of 15p per share over the past 20 years and the current ex dividend market price of its shares is £1.36p. The company is considering accepting a new project, which it will finance by suspending dividends for the next 3 years. After this period, the company will pay an increased dividend of 19p per share for the foreseeable future. If the company takes on the project and uses the proposed method of financing, what will be the expected share price?

- a) £1.36
- b) £1.72
- c) £1.60
- d) £1.26**
- e) £1.13

24. **Questions 24 and 25 refer to the following dividend policies**

- A. Zero dividend payout.
- B. Fixed payout ratio.
- C. Steadily increasing nominal dividend payments.

- D. Special dividend payments.
- E. Constant real dividend payments.

Which of the dividend policies mentioned would best suit a company with a large amount of surplus cash in its balance sheet?

- a) A
- b) B
- c) C
- d) D**
- e) E

25. Which policy would best suit a company whose shareholder clientele is made up predominantly of investors who pay a higher marginal rate of income tax?

- a) A**
- b) B
- c) C
- d) D
- e) E

26. Which of the following statements about the dividend growth model are true?

- a) The model prices shares on the basis of the present value of expected future dividends.
- b) The model relies on the ability to predict a constant future growth rate for dividend payments.
- c) The dividend growth model can accommodate future changes in shareholder's required rate of return.
 - a. 1 and 2 are correct.**
 - b. 2 and 3 are correct
 - c. 1, 2 and 3 are correct
 - d. 3 is correct
 - e. 1 is correct

27. Which of the following techniques does not reward shareholders for investing in a company?

- a) Repurchasing company shares.
- b) Offering non-pecuniary benefits.
- c) Making a rights issue.**
- d) Offering a scrip dividend.
- e) Paying a final dividend.

28. Which of the following statements about tax and dividend payments are correct?

- a) Taxation at a personal level makes capital gains slightly more attractive than dividend payments for smaller investors.
- b) Investors receive dividends net of tax but have to make further payments to the Inland Revenue if they have a high marginal tax rate.
- c) Scrip dividends are taxed like cash dividends by UK tax authorities.
 - a. 2 and 3 are correct
 - b. 1 is correct
 - c. 3 is correct
 - d. 1 and 2 are correct
 - e. 1, 2 and 3 are correct**

29. Which of the following examples best represents a passive dividend policy?

- a. The firm sets a policy such that the proportion of dividends paid from net income remains constant.
- b. The firm pays dividends with what remains of net income after taking acceptable investment projects**
- c. The firm sets a policy such that the quantity (dollar amount per share) of dividends paid from net income remains constant.
- d. All of the above are examples of various types of passive dividend policies

30. Modigliani and Miller argue that the dividend decision _____.

- a. is irrelevant as the value of the firm is based on the earning power of its assets**

- b. is relevant as the value of the firm is not based just on the earning power of its assets
 - c. is irrelevant as dividends represent cash leaving the firm to shareholders, who own the firm anyway
 - d. is relevant as cash outflow always influences other firm decisions
31. Financial signaling has been raised as an argument in the battle over the relevancy of dividends. Which of the following statements concerning dividends is most likely to be voiced by someone using the financial signaling argument?
- a. Dividend decrease should be viewed by investors as "good news." The dividend decrease acts to add conviction to the statement that the firm has better uses for the earnings of the company than the stockholders.
 - b. Reported accounting earnings of a company, not dividends, are a proper reflection or signal of the company's economic earnings.
 - c. The price of a firm's stock should react unfavorably to an increase in dividends.
 - d. **Cash dividends speak louder than words when it comes to conveying information about management's expectations of the future.**
32. A number of legal rules help to establish the legal boundaries within which a firm's finalized dividend policy can operate. These legal rules have to do with capital impairment, insolvency, and undue retention of earnings. Some states have a (an) _____ rule, while the Internal Revenue Service has a (an) _____ rule.
- a. capital impairment; insolvency
 - b. undue retention of earnings; insolvency
 - c. insolvency rule; capital impairment
 - d. **capital impairment (or insolvency); undue retention of earnings**
33. Firm Pickemon, Inc. has had earnings of \$3.20, \$3.00, and \$5.50 per share for the past three years. The firm anticipates maintaining the same dividend policy this year as the past three years. That dividend policy has resulted in dividends per share of \$1.28, \$1.20, and \$2.20 for the past three years. It is anticipated that the next year will result in a large

increase in earnings to \$9.80 per share. What dividend do you expect the firm to pay in the next year?

- a. **\$3.92**
- b. \$1.56
- c. \$3.12
- d. \$4.68

34. Investors may be willing to pay a premium for stable dividends because of the informational content of _____, the desire of investors for _____, and certain _____.

- a. Institutional considerations; dividends; current income
- b. Dividends; current income; institutional considerations.**
- c. Current income; dividends; institutional considerations.
- d. Institutional considerations; current income; dividends.

35. Because various governmental bodies prepare *approved (or legal) lists* of securities in which certain institutions (like pension funds) may invest, companies whose securities appear on these lists _____.

- a. Will think twice before cutting or eliminating a dividend because that will cause them to be removed from the lists.**
- b. do not have to worry about whether they pay a dividend or not because they have been pre-approved
- c. Will want to follow a strictly passive dividend policy.
- d. Are legally authorized to substitute stock dividends for cash dividends.

36. A (n) _____ is a payment of additional shares to shareholders in lieu of cash.

- a. stock split
- b. stock dividend**
- c. extra dividend
- d. regular dividend

37. A (n) _____ occurs when there is an increase in the number of shares outstanding by reducing the par value of stock.
- a. **stock split**
 - b. stock dividend
 - c. extra dividend
 - d. regular dividend
38. A (n) _____ is the expected cash dividend that is normally paid to shareholders.
- a. stock split
 - b. stock dividend
 - c. extra dividend
 - d. **regular dividend**
39. _____ is a nonrecurring dividend paid to shareholders in addition to the regular dividend.
- a. A stock split
 - b. A stock dividend
 - c. **An extra dividend**
 - d. A regular dividend
40. What method of stock repurchase occurs when the buyer seeks bids within a specified price range and accepts the lowest price that will allow it to acquire the entire block of securities desired?
- a. **Dutch-auction**
 - b. Fixed-price
 - c. Open-market
 - d. Fair-warning
41. **What method of stock repurchase occurs when the buyer purchases securities through a brokerage house?**
- a. Dutch-auction

- b. Fixed-price
- c. **Open-market**
- d. Fair-warning

42. The shareholders of your firm anticipate receiving a regular dividend that is consistent with past dividend policies. What benefit occurs to shareholders if the firm repurchases shares with the same total quantity of money that would have been spent on dividends? Assume that the P/E ratio is maintained with either scenario.

- a. **Shareholders can postpone or reduce taxes (assuming a lower capital gain rate).**
- b. It is cheaper for shareholders to sell existing shares for cash than it costs to reinvest cash dividends into existing shares.
- c. The current shareholders benefit because there are a greater number shareholders than if the firm pays a cash dividend.
- d. There is no benefit as shareholders will not be receiving any cash.

43. **A dividend reinvestment plan (DRIP) is _____.**

- a. an optional plan, provided by brokerage firms, allowing shareholders to automatically reinvest dividend payments in additional shares of the firm's stock.
- b. **an optional plan, provided by large corporate firms, allowing shareholders to automatically reinvest dividend payments in additional shares of the firm's stock.**
- c. a mandatory plan, provided by brokerage firms, where shareholders are automatically reinvesting dividend payments in additional shares of the firm's stock at a reduced price.
- d. a mandatory plan, provided by large corporate firms, where shareholders are automatically reinvesting dividend payments in additional shares of the firm's stock at a reduced price.

44. The Board of Directors announces the amount and date of the next dividend on the _____ date; while the _____ date is the first date on which the purchaser of a stock is no longer entitled to the recently declared dividend.

- a. declaration; record

- b. ex-dividend; record
 - c. **declaration; ex-dividend**
 - d. payment; record
45. Which of the following is *not* a reason that a firm would prefer to pay a stock dividend rather than a regular cash dividend?
- a. **It decreases the supply of shares and enhances shareholder wealth.**
 - b. It may conserve cash for other firm needs.
 - c. It will reduce the stock price into what management perceives as a more beneficial trading range.
 - d. It may convey information about the firm to investors that it cannot convey credibly otherwise.
46. According to the authors of your text, the repurchase of stock is considered _____ decision rather than _____ decision.
- a. an investment; a financing
 - b. **a financing; an investment**
 - c. an investment; a dividend
 - d. a dividend; a financing
47. "Large-percentage stock dividends" are typically _____ percent or higher of previously outstanding common stock.
- a. **25**
 - b. 35
 - c. 51
 - d. 70
48. The _____ is the proportion of earnings that are paid to common shareholders in the form of a cash dividend.
- a. retention rate
 - b. 1 plus the retention rate

- c. growth rate
- d. **dividend payout ratio**

49. The weighted average cost of capital for a firm is the:

- a) Discount rate which the firm should apply to all of the projects it undertakes.
- b) Rate of return a firm must earn on its existing assets to maintain the current value of its stock.
- c) Coupon rate the firm should expect to pay on its next bond issue.
- d) Maximum rate which the firm should require on any projects it undertakes.

50. Which one of the following statements is correct concerning the weighted average cost of Capital (WACC):

- a) The WACC may decrease as a firm's debt-equity ratio increases.
- b) When computing the WACC, the weight assigned to the preferred stock is based on the coupon rate multiplied by the par value of the stock.
- c) The weight of the common stock used in the computation of the WACC is based on the number of shares outstanding multiplied by the book value per share.
- d) The WACC will remain constant unless a firm retires some of its debt.

51. Flotation costs should:

- a) Be ignored when analyzing a project because flotation costs are not an actual cost of the project.
- b) Be averaged over the life of the project thereby reducing the cash flows for each year of the project.
- c) Be included in the initial cost of a project before the net present value of the project is computed.
- d) Be ignored totally when internal equity funding is utilized.

52. A critical assumption of the net operating income (NOI) approach to valuation is:

- a) That debt and equity levels remain unchanged.
- b) That dividends increase at a constant rate.

- c) That k_0 remains constant regardless of changes in leverage.
 - d) That interest expense and taxes are included in the calculation.
53. Two firms that are virtually identical except for their capital structure are selling in the market at different values. According to M&M:
- a) One will be at greater risk of bankruptcy.
 - b) The firm with greater financial leverage will have the higher value.
 - c) This proves that markets cannot be efficient.
 - d) This will not continue because arbitrage will eventually cause the firms to sell at the same value.
54. The cost of capital for a firm, when we allow for taxes, bankruptcy, and agency costs:
- a) Remains constant with increasing levels of financial leverage.
 - b) First declines and then ultimately rises with increasing levels of financial leverage.
 - c) Increases with increasing levels of financial leverage.
 - d) Decreases with increasing levels of financial leverage.
55. An EBIT-EPS indifference analysis chart is used for:
- a) Evaluating the effects of business risk on EPS.
 - b) Examining EPS results for alternative financing plans at varying EBIT levels.
 - c) Determining the impact of a change in sales on EBIT.
 - d) Showing the changes in EPS quality over time.
56. Retained earnings are:
- a) An indication of a company's liquidity.
 - b) The same as cash in the bank.
 - c) Not important when determining dividends.
 - d) The cumulative earnings of the company after dividends.
57. Which of the following is an argument for the relevance of dividends?
- a) Informational content.

- b) Reduction of uncertainty.
- c) Some investors' preference for current income.
- d) All of the above.

58. Company Q is all equity financed. For each LKR 1 of earnings, it consistently pays 30% in dividends and retains 70% for reinvestment. It expects to earn a rate of return of 14% on capital employed. According to the Gordon Growth Model, what would the rate of earnings growth be in future? Ignore tax:

- a) 4.2%
- b) 7%
- c) 9.8%
- d) 14%

59. The dividend-payout ratio is equal to:

- a) The dividend yield plus the capital gains yield.
- b) Dividends per share divided by earnings per share.
- c) Dividends per share divided by par value per share.
- d) Dividends per share divided by current price per share.

60. If the CAPM is used to estimate the cost of equity capital, the expected excess market return is equal to the:

- a) Return on the stock minus the risk-free rate.
- b) Difference between the return on the market and the risk-free rate.
- c) Beta times the market risk premium.
- d) Beta times the risk-free rate.
- e) Market rate of return.

61. This type of risk is avoidable through proper diversification:

- a) Portfolio risk
- b) Systematic risk
- c) Unsystematic risk

- d) Total risk
62. A statistical measure of the degree to which two variables (e.g., securities' returns) move together:
- a) Coefficient of variation
 - b) Variance
 - c) Covariance
 - d) Certainty equivalent
63. A line that describes the relationship between an individual security's returns and returns on the market portfolio:
- a) Characteristic line
 - b) Security market line
 - c) Capital market line
 - d) Beta
64. Beta is the slope of
- a) The security market line
 - b) The capital market line
 - c) A characteristic line
 - d) The CAPM
65. Security A has an expected rate of return of 0.10 and a beta of 1.1. The market expected rate of return is 0.08 and the risk-free rate is 0.05. The alpha of the stock is
- a) 1.7%.**
 - b) -1.7%.
 - c) 8.3%.
 - d) 5.5%.
 - e) None of the above.
66. Given the following two stocks A and B
- | <u>Expected rate of return</u> | <u>Beta</u> |
|--------------------------------|-------------|
|--------------------------------|-------------|

A	0.12	1.2
B	0.14	1.8

If the expected market rate of return is 0.09 and the risk-free rate is 0.05, which security would be considered the better buy and why:

- Because it offers an expected excess return of 1.2%.
- Because it offers an expected excess return of 1.8%.
- Because it offers an expected excess return of 2.2%.**
- Because it offers an expected return of 14%.
- Because it has a higher beta.

67. Consider the single-index model. The alpha of a stock is 0%. The return on the market index is 16%. The risk-free rate of return is 5%. The stock earns a return that exceeds the risk-free rate by 11% although there are no firm-specific events affecting the stock performance. The β of the stock is _____.

- 0.67
- 0.75
- 1.0**
- 1.33
- 1.50

68. The index model has been estimated for stocks A and B with the following results:

$$R_A = 0.01 + 0.8R_M + e_A$$

$$R_B = 0.02 + 1.2R_M + e_B$$

$$\sigma_M = 0.20 \quad \sigma(e_A) = 0.20 \quad \sigma(e_B) = 0.10$$

The standard deviation for stock A is _____.

- 0.0656
- 0.0676
- 0.2561**
- 0.2600
- None of the above

69. According to the index model, co variances among security pairs are
- due to the influence of a single common factor represented by the market index return
 - extremely difficult to calculate
 - related to industry-specific events
 - usually positive
 - a and d**
70. Consider the single-index model. The alpha of a stock is 0%. The return on the market index is 16%. The risk-free rate of return is 5%. The stock earns a return that exceeds the risk-free rate by 11% although there are no firm-specific events affecting the stock performance. The β of the stock is _____.
- 0.67
 - 0.75
 - 1.0**
 - 1.33
 - 1.50
71. The index model has been estimated for stocks A and B with the following results:
- $$R_A = 0.01 + 0.5R_M + e_A$$
- $$R_B = 0.02 + 1.3R_M + e_B$$
- $$\sigma_M = 0.25 \quad \sigma(e_A) = 0.20 \quad \sigma(e_B) = 0.10$$
- The covariance between the returns on stocks A and B is _____.
- 0.0384
 - 0.0406**
 - 0.1920
 - 0.0050
 - 0.4000
72. Suppose two portfolios have the same average return, the same standard deviation of returns, but portfolio A has a higher beta than portfolio B. According to the Sharpe measure, the performance of portfolio A _____.

- a) is better than the performance of portfolio B
- b) is the same as the performance of portfolio B**
- c) is poorer than the performance of portfolio B
- d) cannot be measured as there is no data on the alpha of the portfolio
- e) None of the above is true.

73. Consider the Sharpe and Treynor performance measures. When a pension fund is large and has many managers, the _____ measure is better for evaluating individual managers while the _____ measure is better for evaluating the manager of a small fund with only one manager responsible for all investments.

- a) Sharpe, Sharpe
- b) Sharpe, Treynor
- c) Treynor, Sharpe**
- d) Treynor, Treynor
- e) Both measures are equally good in both cases.

74. Suppose you purchase 100 shares of GM stock at the beginning of year 1, and purchase another 100 shares at the end of year 1. You sell all 200 shares at the end of year 2. Assume that the price of GM stock is \$50 at the beginning of year 1, \$55 at the end of year 1, and \$65 at the end of year 2. Assume no dividends were paid on GM stock. Your dollar-weighted return on the stock will be _____; your time-weighted return on the stock.

- a) higher than**
- b) the same as
- c) less than
- d) exactly proportional to
- e) more information is necessary to answer this question

75. Suppose the risk-free return is 6%. The beta of a managed portfolio is 1.5, the alpha is 3%, and the average return is 18%. Based on Jensen's measure of portfolio performance, you would calculate the return on the market portfolio as

- a) **12%**
- b) 14%
- c) 15%
- d) 16%
- e) None of the above

76. You want to evaluate three mutual funds using the Jensen measure for performance evaluation. The risk-free return during the sample period is 6%, and the average return on the market portfolio is 18%. The average returns, standard deviations, and betas for the three funds are given below.

	<u>Average Return</u>	<u>Standard. Deviation</u>	<u>Beta</u>
Fund A	17.6%	10%	1.2
Fund B	17.5%	20%	1.0
Fund C	17.4%	30%	0.8

The fund with the highest Jensen measure is _____.

- a) Fund A
- b) Fund B
- c) **Fund C**
- d) Funds A and B are tied for highest
- e) Funds A and C are tied for highest

77. Suppose you purchase one share of the stock of Cereal Correlation Company at the beginning of year 1 for \$50. At the end of year 1, you receive a \$1 dividend, and buy one more share for \$72. At the end of year 2, you receive total dividends of \$2 (i.e., \$1 for each share), and sell the shares for \$67.20 each. The time-weighted return on your investment is _____.

- a) 10.00%
- b) 8.78%
- c) 19.71%
- d) **20.36%**
- e) None of the above

78. Suppose you own two stocks, A and B. In year 1, stock A earns a 2% return and stock B earns a 9% return. In year 2, stock A earns an 18% return and stock B earns an 11% return. Which stock has the higher geometric average return?

- a) stock A
- b) stock B**
- c) the two stocks have the same geometric average return
- d) at least three periods are needed to calculate the geometric average return.
- e) none of the above

Use the following to answer question 79:

The following data are available relating to the performance of Caribou Stock Fund and the market portfolio:

	<u>Caribou</u>	<u>Market Portfolio</u>
Average Return	18%	15%
Standard Deviation of Returns	25%	20%
Beta	1.25	1.00
Residual Standard Deviation	2%	0%

The risk-free return during the sample period was 7%.

79. What is the appraisal ratio measure of performance evaluation for Caribou Stock Fund?

- a) 1.00%
- b) 8.80%
- c) 44.00%
- d) 50.00%**
- e) None of the above

Use the following to answer question 80:

The following data are available relating to the performance of High Variance Stock Fund and the market portfolio:

	<u>High Variance</u>	<u>Market Portfolio</u>
Average Return	19%	12%
Standard Deviation of Returns	35%	15%
Beta	1.5	1.0
Residual standard deviation	3.0%	0.0%

The risk-free return during the sample period was 6%.

80. What is the Sharpe measure of performance evaluation for High Variance Stock Fund?

- a) 1.33%
- b) 4.00%
- c) 8.67%
- d) 31.43%
- e) **37.14%**

81. The portfolio performance evaluation measure, known as M-squared, uses _____ as the relevant measure of risk and is based on the ex-post capital market line.

- a) **standard deviation**
- b) arithmetic mean
- c) variation
- d) beta

Use the following to answer questions 82-83:

In a particular year, Bullish Mutual Fund earned a return of 1% by making the following investments in asset classes:

	<u>Weight</u>	<u>Return</u>
Bonds	20%	5%
Stocks	80%	0%

The return on a bogey portfolio was 2%, calculated from the following information.

	<u>Weight</u>	<u>Return</u>
Bonds(Lehman Brothers Index)	50%	5%
Stocks(S&P 500 Index)	50%	-1%

82. The total excess return on the Bullish Fund's managed portfolio was _____.

- a) -1.80%
- b) -1.00%**
- c) 0.80%
- d) 1.00%
- e) None of the above

83. The contribution of asset allocation across markets to the Bullish Fund's total excess return was _____.

- a) -1.80%**
- b) -1.00%
- c) 0.80%
- d) 1.00%
- e) None of the above

84. The contribution of selection within markets to the Bullish Fund's total excess return was _____.

- a) -1.80%
- b) -1.00%
- c) 0.80%**
- d) 1.00%
- e) None of the above

85. Risk-adjusted mutual fund performance measures have decreased in popularity because

- a) In nearly efficient markets it is extremely difficult for portfolio managers to outperform the market.
- b) The measures usually result in negative performance results for the portfolio managers.
- c) The high rates of return earned by the mutual funds in recent years have made the measures useless.
- d) a and b.**
- e) None of the above.

86. The Jensen portfolio evaluation measure

- a) is a measure of return per unit of risk, as measured by standard deviation.
- b) is an absolute measure of return over and above that predicted by the CAPM.**
- c) is a measure of return per unit of risk, as measured by beta.
- d) **a and b.**
- e) **b and c.**

87. Empirical research by DeBondt and Thaler (1985), Jagadeesh (1990) and Lehman (1990)

- a) Found that poorly stocks that performed poorly in one period experienced sizable reversals in the subsequent period**
- b) Found that stocks that performed poorly in one period experienced poor performance in the subsequent period
- c) Found that stocks that performed poorly in one period experienced neither better nor worse performance than other stocks in the subsequent period
- d) Did not try to test the reversal effect
- e) Reinforces the EMH

88. Studies of mutual fund performance

- a) Indicate that one should not randomly select a mutual fund.
- b) Indicate that historical performance is not necessarily indicative of future performance.
- c) Indicate that the professional management of the fund insures above market returns.
- d) a and b.**
- e) **b and c.**

89. The primary goal of a publicly-owned firm interested in serving its stockholders should be to

- a) Maximize expected total corporate profit.
- b) Maximize expected EPS.
- c) Minimize the chances of losses.

d) **Maximize the stock price per share.**

e) Maximize expected net income.

90. Which of the following actions are likely to reduce agency conflicts between stockholders and managers?

a. Paying managers a large fixed salary.

b. **Increasing the threat of corporate takeover.**

c. Placing restrictive covenants in debt agreements.

d. All of the statements above are correct.

e. Statements b and c are correct.

91. In recent years, both expected inflation and the market risk premium ($k_M - k_{RF}$) have declined. Assume that all stocks have positive betas. Which of the following is likely to have occurred as a result of these changes?

a. The average required return on the market, k_M , has remained constant, but the required returns have fallen for stocks that have betas greater than 1.0.

b. The required returns on all stocks have fallen by the same amount.

c. **The required returns on all stocks have fallen, but the decline has been greater for stocks with higher betas.**

d. The required returns on all stocks have fallen, but the decline has been greater for stocks with lower betas.

e. The required returns have increased for stocks with betas greater than 1.0 but have declined for stocks with betas less than 1.0.

92. The risk-free rate is 5 percent. Stock A has a beta = 1.0 and Stock B has a beta = 1.4. Stock A has a required return of 11 percent. What is Stock B's required return?

a. 12.4%

b. **13.4%**

c. 14.4%

d. 15.4%

e. 16.4%

93. Assume that the risk-free rate is 5 percent and that the market risk premium is 7 percent. If a stock has a required rate of return of 13.75 percent, what is its beta?
- a. **1.25**
 - b. 1.35
 - c. 1.37
 - d. 1.60
 - e. 1.96
94. What is the present value of a 5-year ordinary annuity with annual payments of \$200, evaluated at a 15 percent interest rate?
- a. **\$ 670.43**
 - b. \$ 842.91
 - c. \$1,169.56
 - d. \$1,348.48
 - e. \$1,522.64
95. If markets are in equilibrium, which of the following will occur:
- a. Each investment's expected return should equal its realized return.
 - b. **Each investment's expected return should equal its required return.**
 - c. Each investment should have the same expected return.
 - d. Each investment should have the same realized return.
 - e. All of the statements above are correct.
96. Johnston Corporation is growing at a constant rate of 6 percent per year. It has both common stock and non-participating preferred stock outstanding. The cost of preferred stock (k_p) is 8 percent. The par value of the preferred stock is \$120, and the stock has a stated dividend of 10 percent of par. What is the market value of the preferred stock?
- a. \$125
 - b. \$120
 - c. \$175
 - d. **\$150**

e. \$200

97. A share of common stock has just paid a dividend of \$2.00. If the expected long-run growth rate for this stock is 15 percent, and if investors require a 19 percent rate of return, what is the price of the stock?

- a. **\$57.50**
- b. \$62.25
- c. \$71.86
- d. \$64.00
- e. \$44.92

98. Cartwright Brothers' stock is currently selling for \$40 a share. The stock is expected to pay a \$2 dividend at the end of the year. The stock's dividend is expected to grow at a constant rate of 7 percent a year forever. The risk-free rate (k_{RF}) is 6 percent and the market risk premium ($k_M - k_{RF}$) is also 6 percent. What is the stock's beta?

- a. 1.06
- b. **1.00**
- c. 2.00
- d. 0.83
- e. 1.08

99. A project has an up-front cost of \$100,000. The project's WACC is 12 percent and its net present value is \$10,000. Which of the following statements is most correct?

- a. The project should be rejected since its return is less than the WACC.
- b. **The project's internal rate of return is greater than 12 percent.**
- c. The project's modified internal rate of return is less than 12 percent.
- d. All of the statements above are correct.
- e. None of the statements above is correct.

100. A decrease in the debt ratio will generally have no effect on _____.

- a. Financial risk.
- b. Total risk.
- c. **Business risk.**
- d. Market risk.
- e. None of the above is correct. (It will affect each type of risk above.)

101. From the information below, select the optimal capital structure for Minnow Entertainment Company.

- a. Debt = 40%; Equity = 60%; EPS = \$2.95; Stock price = \$26.50.
- b. Debt = 50%; Equity = 50%; EPS = \$3.05; Stock price = \$28.90.
- c. **Debt = 60%; Equity = 40%; EPS = \$3.18; Stock price = \$31.20.**
- d. Debt = 80%; Equity = 20%; EPS = \$3.42; Stock price = \$30.40.
- e. Debt = 70%; Equity = 30%; EPS = \$3.31; Stock price = \$30.00.

102. Which of the following statements best describes the optimal capital structure?

- a. The optimal capital structure is the mix of debt, equity, and preferred stock that maximizes the company's earnings per share (EPS).
- b. The optimal capital structure is the mix of debt, equity, and preferred stock that maximizes the company's stock price.
- c. The optimal capital structure is the mix of debt, equity, and preferred stock that minimizes the company's weighted average cost of capital (WACC).
- d. Statements a and b are correct.
- e. **Statements b and c are correct.**

102. Which of the following factors is likely to encourage a corporation to increase the proportion of debt in its capital structure?

- a. **An increase in the corporate tax rate.**
- b. An increase in the personal tax rate.
- c. An increase in the company's degree of operating leverage.
- d. The company's assets become less liquid.

- e. An increase in expected bankruptcy costs.
103. The Price Company will produce 55,000 widgets next year. Variable costs will equal 40 percent of sales, while fixed costs will total \$110,000. At what price must each widget be sold for the company to achieve an EBIT of \$95,000?
- a. \$2.00
 - b. \$4.45
 - c. \$5.00
 - d. \$5.37
 - e. **\$6.21**
104. Which of the following statements best describes the theories of investors' preferences for dividends?
- a. Modigliani and Miller argue that investors prefer dividends to capital gains.
 - b. The bird-in-hand theory suggests that a company can reduce its cost of equity capital by reducing its dividend payout ratio.
 - c. The tax preference theory suggests that a company can increase its stock price by increasing its dividend payout ratio.
 - d. One key advantage of a residual dividend policy is that it enables a company to follow a stable dividend policy.
 - e. **The clientele effect suggests that companies should follow a stable dividend policy.**
105. Trenton Publishing follows a strict residual dividend policy. All else being equal, which of the following factors are likely to cause an increase in the firm's per-share dividend?
- a. **An increase in its net income.**
 - b. The company increases the proportion of equity financing in its target capital structure.
 - c. An increase in the number of profitable projects that it wants to fund this year.
 - d. Statements a and b are correct.
 - e. All of the statements above are correct.

106. Albany Motors recently completed a 3-for-1 stock split. Prior to the split, the company had 10 million shares outstanding and its stock price was \$150 per share. After the split, the total market value of the company's stock equaled \$1.5 billion. What was the price of the company's stock following the stock split?
- a. \$ 15
 - b. \$ 45
 - c. **\$ 50**
 - d. \$150
 - e. \$450
107. Tarheel Computing's stock was trading at \$150 per share before its recent 3-for-1 stock split. The 3-for-1 split led to a 5 percent increase in Tarheel's market capitalization. (Market capitalization equals the stock price times the number of shares.) What was Tarheel's price after the stock split?
- a. \$472.50
 - b. \$ 50.00
 - c. \$ 47.62
 - d. \$428.57
 - e. **\$ 52.50**
108. Brock Brothers wants to maintain its capital structure that consists of 30 percent debt and 70 percent equity. The company forecasts that its net income this year will be \$1,000,000. The company follows a residual dividend policy and anticipates a dividend payout ratio of 40 percent. What is the size of the company's capital budget?
- a. \$ 600,000
 - b. **\$ 857,143**
 - c. \$1,000,000
 - d. \$1,428,571
 - e. \$2,000,000

109. Makeover Inc. believes that at its current stock price of \$16.00 the firm is undervalued in the market. Makeover plans to repurchase 2.4 million of its 20 million shares outstanding. The firm's managers expect that they can repurchase the entire 2.4 million shares at the expected equilibrium price after repurchase. The firm's current earnings are \$44 million. If management's assumptions hold, what is the expected per-share market price after repurchase?
- a. \$16.00
 - b. \$17.26
 - c. **\$18.18**
 - d. \$20.00
 - e. \$24.40
110. Myron Gordon and John Lintner believe that the required return on equity increases as the dividend payout ratio is decreased. Their argument is based on the assumption that
- a. Investors are indifferent between dividends and capital gains.
 - b. Investors require that the dividend yield and capital gains yield equal a constant.
 - c. Capital gains are taxed at a higher rate than dividends.
 - d. **Investors view dividends as being less risky than potential future capital gains.**
 - e. Investors value a dollar of expected capital gains more highly than a dollar of expected dividends because of the lower tax rate on capital gains.
111. Which of the following statements is most correct?
- a. In general, stock repurchases are taxed the same way as dividends.
 - b. One nice feature of dividend reinvestment plans is that they enable investors to reduce the taxes paid on their dividends.
 - c. On average, companies send a negative signal to the marketplace when they announce an increase in their dividend.
 - d. **If a company is interested in issuing new equity capital, a new stock dividend reinvestment plan probably makes more sense than an open market dividend reinvestment plan.**
 - e. Statements b and d are correct.

112. In the real world, we find that dividends

- a. **Usually exhibit greater stability than earnings.**
- b. Fluctuate more widely than earnings.
- c. Tend to be a lower percentage of earnings for mature firms.
- d. Are usually changed every year to reflect earnings changes.
- e. Are usually set as a fixed percentage of earnings.

113. A decrease in a firm's willingness to pay dividends is likely to result from an increase in its

- a. Earnings stability.
- b. Access to capital markets.
- c. **Profitable investment opportunities.**
- d. Collection of accounts receivable.
- e. Stock price.

114. Which of the following statements best describes the theories of investors' preferences for dividends?

- a. Modigliani and Miller argue that investors prefer dividends to capital gains.
- b. The bird-in-hand theory suggests that a company can reduce its cost of equity capital by reducing its dividend payout ratio.
- c. The tax preference theory suggests that a company can increase its stock price by increasing its dividend payout ratio.
- d. One key advantage of a residual dividend policy is that it enables a company to follow a stable dividend policy.
- e. **The clientele effect suggests that companies should follow a stable dividend policy.**

115. Which of the following statements is most correct?

- a. The bird-in-the-hand theory implies that a company can reduce its WACC by reducing its dividend payout.
- b. The bird-in-the-hand theory implies that a company can increase its stock price by reducing its dividend payout.

c. One problem with following a residual dividend policy is that it can lead to erratic dividend payouts that may prevent the firm from establishing a reliable clientele of investors who prefer a particular dividend policy.

d. Statements a and c are correct.

e. All of the statements above are correct.

116. Which of the following would not have an influence on the optimal dividend policy?

a. The possibility of accelerating or delaying investment projects.

b. A strong shareholders' preference for current income versus capital gains.

c. Bond indenture constraints.

d. The costs associated with selling new common stock.

e. All of the statements above can have an effect on dividend policy.

117. Trenton Publishing follows a strict residual dividend policy. All else being equal, which of the following factors are likely to cause an increase in the firm's per-share dividend?

a. An increase in its net income.

b. The company increases the proportion of equity financing in its target capital structure.

c. An increase in the number of profitable projects that it wants to fund this year.

d. Statements a and b are correct.

e. All of the statements above are correct.

118. A stock split will cause a change in the total dollar amounts shown in which of the following balance sheet accounts?

a. Cash.

b. Common stock.

c. Paid-in capital.

d. Retained earnings.

e. None of the statements above is correct.

119. You currently own 100 shares of stock in Beverly Brothers Inc. The stock currently trades at \$120 a share. The company is contemplating a 2-for-1 stock split. Which of the following best describes your position after the proposed stock split takes place?

- a. You will have 200 shares of stock, and the stock will trade at or near \$120 a share.
- b. You will have 200 shares of stock, and the stock will trade at or near \$60 a share.**
- c. You will have 100 shares of stock, and the stock will trade at or near \$60 a share.
- d. You will have 50 shares of stock, and the stock will trade at or near \$120 a share.
- e. You will have 50 shares of stock, and the stock will trade at or near \$60 a share.

120. Which of the following statements is most correct?

- a. One advantage of stock repurchases is that they are generally taxed more favorably than dividend payments.**
- b. One advantage of dividend reinvestment plans is that they enable investors to avoid paying taxes on the dividends they receive.
- c. Stock repurchases make sense if a company is interested in increasing its equity ratio.
- d. Stock repurchases make sense if a company believes that its stock is overvalued and that it has a lot of profitable projects to fund over the next year.
- e. One advantage of an open market dividend reinvestment plan is that it increases the number of shares the company has outstanding.

121. Which of the following statements is most correct?

- a. One reason that companies tend to avoid stock repurchases is that dividend payments are taxed more favorably than stock repurchases.
- b. One advantage of dividend reinvestment plans is that they allow shareholders to avoid paying taxes on the dividends that they choose to reinvest.
- c. If a company announces a 2-for-1 stock split and the overall value of the firm remains unchanged, the company's stock price must have doubled.
- d. All of the statements above are correct.
- e. None of the statements above is correct.**

122. Which of the following statements is most correct?

- a. The tax code encourages companies to pay dividends.
- b. If a company uses the residual dividend model to determine its dividend payout ratio, its dividend payout will tend to increase whenever it has a large number of investment opportunities.
- c. The clientele effect encourages companies to adopt a strict version of the residual dividend model.
- d. In many cases, stock repurchases tend to increase earnings per share, but they also increase the firm's debt ratio and financial risk.**
- e. Stock repurchases are taxed the same way as dividends are taxed.

123. Which of the following statements is most correct?

- a. If a company puts in place a 2-for-1 stock split, its stock price should roughly double.
- b. Share repurchases are taxed less favorably than dividends; this explains why companies typically pay dividends and avoid share repurchases.
- c. On average, a company's stock price tends to rise when it announces that it is initiating a share repurchase program.**
- d. Statements a and b are correct.
- e. All of the statements above are correct.

124. Which of the following statements is most correct?

- a. The bird-in-the-hand theory argues that investors prefer dividends because dividends are taxed more favorably than capital gains.
- b. Stock repurchases increase the number of outstanding shares.
- c. The clientele effect can explain why companies tend to vary their dividends a lot on a year-to-year basis.
- d. Statements a and b are correct.
- e. None of the statements above is correct.**

125. Which of the following statements is most correct?

- a. The tax preference hypothesis suggests that companies can reduce their costs of capital by increasing their dividend payout ratios.
- b. One advantage of the residual dividend policy is that it leads to a stable dividend payout, which is desired by investors.
- c. Firms with a large number of investment opportunities and a relatively small amount of cash tend to have above average dividend payouts.
- d. Statements a and b are correct.
- e. **None of the statements above is correct.**

126. Which of the following statements is most correct?

- a. **The tax preference theory states that, all else equal, investors prefer stocks that pay low dividends because retained earnings can lead to capital gains that are taxed at a lower rate.**
- b. An increase in the cost of equity capital (k_e) when a company announces an increase in its dividend per share, would be consistent with the bird-in-the-hand theory.
- c. An increase in the stock price when a company decreases its dividend is consistent with the signaling theory.
- d. A dividend policy that involves paying a consistent percentage of net income is the best policy if the “clientele effect” is correct.
- e. Statements a and d are correct.

127. Which of the following statements is most correct?

- a. The Tax Code encourages companies to pay large dividends to their shareholders.
- b. **If your company has established a clientele of investors who prefer large dividends, the company is unlikely to adopt a residual dividend policy.**
- c. If a firm follows a residual dividend policy, holding all else constant, its dividend payout will tend to rise whenever the firm’s investment opportunities improve.
- d. Statements b and c are correct.
- e. All of the statements above are correct.

128. Which of the following statements is most correct?

- a. If Congress cuts the capital gains rate, but leaves the personal tax rate unchanged, then this would provide an incentive for companies to increase their dividend payouts.
- b. Despite its drawbacks, a residual dividend policy is an effective way to stabilize dividend payouts, which makes it easier for firms to attract a clientele that prefers high dividends.
- c. If a firm follows a residual dividend policy, then a sudden increase in the number of profitable projects is likely to reduce the firm's dividend payout.**
- d. All of the statements above are correct.
- e. None of the statements above is correct.

129. Which of the following statements is most correct?

- a. The bird-in-the-hand theory would predict that companies could decrease their cost of equity financing by raising their dividend payout.**
- b. The clientele effect can explain why firms often change their dividend policies.
- c. One advantage of adopting a residual dividend policy is that it makes it easier for corporations to maintain dividend clienteles.
- d. Statements a and c are correct.
- e. None of the statements above is correct.

130. If a firm adheres strictly to the residual dividend policy, a sale of new common stock by the company would suggest that

- a. The dividend payout ratio has remained constant.
- b. The dividend payout ratio is increasing.
- c. No dividends were paid for the year.**
- d. The dividend payout ratio is decreasing.
- e. The dollar amount of investments has decreased.

131. If a firm adheres strictly to the residual dividend policy, then if its optimal capital budget requires the use of all earnings for that year (along with new debt according to the optimal debt/total assets ratio), the firm should pay

- a. No dividends except out of past retained earnings.
- b. No dividends to common stockholders.**
- c. Dividends, in effect, out of a new issue of common stock.
- d. Dividends by borrowing the money (debt).
- e. Either statement c or statement d above could be used.

132. Modigliani and Miller (MM) argued that dividend policy is irrelevant. On the other hand, Gordon and Lintner (GL) argued that dividend policy does matter. GL's argument rests on the contention that

- a. $k_s = D_1/P_0 + g$ is constant for any dividend policy.
- b. Because of perceived differences in risk, investors value a dollar of dividends more highly than a dollar of expected capital gains.**
- c. Investors, because of tax differentials, value a dollar of expected capital gains more highly than a dollar of dividends.
- d. Most investors will reinvest rather than spend dividends, so it would save investors money (taxes) if corporations simply reinvested earnings rather than paid them out as dividends.
- e. None of the statements above is correct.

133. Congress passed a new tax law that reduced long-term capital gains tax rates from 28 percent to 20 percent. The maximum tax rate for ordinary personal income is 38.6 percent. Which of the following statements is most correct for an investor in a high personal tax bracket?

- a. The stock of a company that pays high cash dividends and has a dividend reinvestment plan (DRIP) is a good investment for this individual because he/she will receive more money that can then be reinvested in the company's stock.
- b. A 2-for-1 stock split is announced for a stock that the investor currently holds. The company had split the stock because the stock price had increased beyond the optimal price range and is expected to continue to grow. This is good news to the investor because it means that any gains from increased stock value will be taxed at a new lower long-term capital gains rate when the stock is sold.

c. One of the companies in the investor's portfolio recently announced that it will embark on a stock repurchase plan. The lower long-term capital gains tax rate will reduce the investor's taxes if he/she decides to tender some shares of stock in the company.

d. Statements b and c are correct.

e. All of the statements above are correct.

134. Which of the following statements is most correct?

a. "New-stock" dividend reinvestment plans are similar to stock dividends because they both increase the number of shares outstanding but don't change the total equity of a firm.

b. Investors receiving stock dividends must pay taxes on the new shares at the time the stock dividends are received.

c. Stockholders pay no income tax on dividends reinvested in a dividend reinvestment plan.

d. Statements a and b are correct.

e. None of the statements above is correct.

135. Which of the following statements is most correct?

a. Stock repurchases can be used by firms to defend against hostile takeovers since they increase the proportion of debt in a firm's capital structure.

b. After a 3-for-1 stock split, a company's price per share will fall and its number of shares outstanding will rise.

c. Investors can interpret a stock repurchase by a firm as a signal that the firm's managers believe the stock is underpriced.

d. Statements a and b are correct.

e. All of the statements above are correct.

136. Which of the following statements is most correct?

a. Companies can repurchase shares either (1) to change their capital structures or (2) to distribute cash to stockholders without paying cash dividends. In the second situation, tax considerations will probably play a key role in the decision to repurchase stock versus to pay more cash dividends.

- b. Stock dividends provide investors with additional shares of stock, not cash, yet many investors must pay cash in the form of taxes on the value of the stock dividends. For this reason, stock dividends are rarely used today.
- c. The bird-in-the-hand theory of dividend policy could be rejected immediately if personal income taxes were abolished.
- d. If the curve relating the WACC and the debt ratio looks like a sharp “V,” this would make it more feasible for a firm to follow the residual dividend policy than if the curve looks like a shallow bowl (or a shallow “U”).
- e. The open market type of dividend reinvestment plan is the best type for firms that need to bring in new equity capital.

137. Which of the following statements is most correct?

- a. If a firm repurchases its stock in the open market, the shareholders that tender are subject to capital gains taxes.
- b. If you own 100 shares in a company’s stock, and the company does a 2-for-1 stock split, you will own 200 shares in the company following the split.
- c. Some dividend reinvestment plans increase the amount of equity capital available to the firm.
- d. Statements a and b are correct.**
- e. All of the statements above are correct.

138. Which of the following statements is most correct?

- a. An open-market dividend reinvestment plan is likely to be attractive to companies that are looking to issue additional shares of common stock.
- b. Stock repurchases have the effect of reducing financial leverage.
- c. If a company does a 2-for-1 stock split, its stock price will roughly double.
- d. All of the statements above are correct.
- e. None of the statements above is correct.**

139. Which of the following statements is most correct?

- a. **If a company wants to issue new shares of common stock and also wants to implement a dividend reinvestment plan, then it should implement a new-stock dividend reinvestment plan, rather than an open-market purchase plan.**
- b. If a company undertakes a 3-for-1 stock split, then the number of shares outstanding should fall, and the stock price should rise.
- c. If a company wants to reduce its debt ratio, then it should repurchase some of its common stock.
- d. Statements a and c are correct.
- e. Statements b and c are correct.

140. Which of the following statements is most correct?

- a. If you were testing dividend theories and found that a dividend increase resulted in higher stock prices, then you could rule out all other theories and conclude that the bird-in-the-hand theory was most consistent with the evidence you found.
- b. The clientele effect suggests that investors choose their investments based on firms' past dividend policies and changes to established dividend policies may be costly to investors.
- c. Dividends paid under a residual dividend policy might send conflicting signals to investors.
- d. **Statements b and c are correct.**
- e. All of the statements above are correct.

141. Which of the following actions will enable a company to raise additional equity capital (that is, which of the following will raise the total book value of equity)?

- a. **The establishment of a new-stock dividend reinvestment plan.**
- b. A stock split.
- c. The establishment of an open-market purchase dividend reinvestment plan.
- d. A stock repurchase.
- e. Statements a and d are correct.

142. Firm M is a mature firm in a mature industry. Its annual net income and net cash flow are both consistently high and very stable. The company's growth prospects are quite limited; therefore, the company's capital budget is small relative to its net income. Firm N is a relatively new firm in a new industry. Its annual operating income fluctuates considerably, but the company has substantial growth opportunities. Its capital budget is expected to be large relative to its net income for the foreseeable future. Which of the following statements is most correct?

- a. Firm M probably has a lower debt ratio than Firm N.
- b. Firm M probably has a higher dividend payout ratio than Firm N.**
- c. If the corporate tax rate increases, the debt ratio of both firms is likely to fall.
- d. Statements a and b are correct.
- e. Statements b and c are correct.

143. Petersen Co. has a capital budget of \$1,200,000. The company wants to maintain a target capital structure that consists of 60 percent debt and 40 percent equity. The company forecasts that its net income this year will be \$600,000. If the company follows a residual dividend policy, what will be its payout ratio?

- a. 0%
- b. 20%**
- c. 40%
- d. 60%
- e. 80%

144. Chandler Communications' CFO has provided the following information:

- The company's capital budget is expected to be \$5,000,000.
- The company's target capital structure is 70 percent debt and 30 percent equity.
- The company's net income is \$4,500,000.

If the company follows a residual dividend policy, what portion of its net income should it pay out as dividends this year?

- a. 33.33%
- b. 40.00%**

- c. 50.00%
- d. 60.00%
- e. 66.67%**

145. Strategic Systems Inc. expects to have net income of \$800,000 during the next year. Its target, and current, capital structure is 40 percent debt and 60 percent common equity. The Director of Capital Budgeting has determined that the optimal capital budget for next year is \$1.2 million. If Strategic uses the residual dividend model to determine next year's dividend payout, what is the expected dividend payout ratio?

- a. 0%
- b. 10%**
- c. 28%
- d. 42%
- e. 56%

146. Powell Products anticipates that its capital budget next year will be \$3 million. The company expects to report net income of \$5 million this year. The company's target capital structure is 65 percent common equity and 35 percent long-term debt. Assume the company follows a strict residual dividend policy. What is the expected dividend payout ratio this year?

- a. 65%
- b. 39%
- c. 61%**
- d. 56%
- e. 100%

147. Arden Manufacturing follows a strict residual dividend policy. The company is forecasting that its net income will be \$500 million this year. The company anticipates that its capital budget will be \$250 million. The company has a target capital structure that consists of 50 percent equity and 50 percent long-term debt. What is the company's anticipated dividend payout ratio?

- a. **75%**
- b. 55%
- c. 50%
- d. 25%
- e. 47%

148. Redwood Systems follows a strict residual dividend policy. The company estimates that its capital expenditures this year will be \$40 million, its net income will be \$30 million, and its target capital structure is 60 percent equity and 40 percent debt. What will be the company's dividend payout ratio?

- a. 80%
- b. 60%
- c. 40%
- d. **20%**
- e. 15%

149. Wolfpack Multimedia follows a strict residual dividend policy. Wolfpack forecasts that its net income will be \$12 million this year. The company has no depreciation expense so its net cash flow is \$12 million, and its target capital structure consists of 70 percent equity and 30 percent debt. Wolfpack's capital budget is \$10 million. What is the company's dividend payout ratio?

- a. 16.67%
- b. **41.67%**
- c. 11.67%
- d. 0.00%
- e. 58.30%

150. Plato Inc. expects to have net income of \$5,000,000 during the next year. Plato's target capital structure is 35 percent debt and 65 percent equity. The company's director of capital budgeting has determined that the optimal capital budget for the coming year is \$6,000,000.

If Plato follows a residual dividend policy to determine the coming year's dividend, then what is Plato's payout ratio?

- a. 38%
- b. 42%
- c. 58%
- d. 33%
- e. **22%**

151. Simon Utility expects to have net income of \$5 billion this year. The company has an estimated capital budget of \$4 billion, and its capital structure consists of 65 percent common equity and 35 percent debt. If the company follows a strict residual dividend policy, what is the company's expected dividend payout ratio?

- a. 0.00%
- b. 35.00%
- c. **48.00%**
- d. 65.00%
- e. 100.00%

152. Bettis Bus Co. uses the residual dividend model to determine its common dividend payout. This year the company expects its net income to be \$2 million, and it expects to have a 25 percent common dividend payout ratio. The company's target common equity ratio is 40 percent, and the firm is financed with only common equity and debt. What is the company's forecasted total capital budget for the year?

- a. \$1.25 million
- b. \$2.25 million
- c. \$2.50 million
- d. \$3.25 million
- e. **\$3.75 million**

153. Allensworth Motors forecasts that its earnings per share will be \$3.00 this year. The

company has 500 million shares of stock outstanding. Allensworth estimates that its capital budget for the upcoming year will be \$800 million, and it is committed to funding the entire capital budget. The company is also committed to maintaining its dividend of \$2.00 per share, and it wants to avoid issuing new common stock. The company's capital structure consists of debt and common stock. Given the above constraints, what portion of the \$800 million capital budget will be funded with debt?

- a. 53.13%
- b. 46.02%
- c. 40.00%
- d. 6.25%
- e. **37.50%**

154. Albany Motors recently completed a 3-for-1 stock split. Prior to the split, the company had 10 million shares outstanding and its stock price was \$150 per share. After the split, the total market value of the company's stock equaled \$1.5 billion. What was the price of the company's stock following the stock split?

- a. \$ 15
- b. \$ 45
- c. **\$ 50**
- d. \$150
- e. \$450

155. Loisel Graphics recently announced a 3-for-1 stock split. Prior to the split, the company's stock was trading at \$90 per share. The split had no effect on the wealth of the company's investors. What will be the new stock price?

- a. \$270
- b. \$ 45
- c. \$180
- d. \$ 60
- e. **\$ 30**

156. Urlacher Digital's stock is trading at \$120 a share. The company plans to announce a 3-for-2 stock split. The stock split is expected to increase the company's market capitalization by 5 percent. What is the expected stock price after the stock split is completed?

- a. \$189.00
- b. \$ 84.00**
- c. \$ 80.00
- d. \$ 50.40
- e. \$ 75.60

157. Tarheel Computing's stock was trading at \$150 per share before its recent 3-for-1 stock split. The 3-for-1 split led to a 5 percent increase in Tarheel's market capitalization. (Market capitalization equals the stock price times the number of shares.) What was Tarheel's price after the stock split?

- a. \$472.50
- b. \$ 50.00
- c. \$ 47.62
- d. \$428.57
- e. \$ 52.50**

158. Flavortech Inc. expects EBIT of \$2,000,000 for the coming year. The firm's capital structure consists of 40 percent debt and 60 percent equity, and its marginal tax rate is 40 percent. The cost of equity is 14 percent, and the company pays a 10 percent interest rate on its \$5,000,000 of long-term debt. One million shares of common stock are outstanding. In its next capital budgeting cycle, the firm expects to fund one large positive NPV project costing \$1,200,000, and it will fund this project in accordance with its target capital structure. Assume that new debt will also have an interest rate of 10 percent. If the firm follows a residual dividend policy and has no other projects, what is its expected dividend payout ratio?

- a. 82.6%
- b. 60.0%
- c. 40.0%
- d. 17.4%**
- e. 5.6%

159. Grant Grocers is considering the following independent, average-risk investment projects:

<u>Project</u>	<u>Size of Project</u>	<u>Project IRR</u>
Project V	\$1.0 million	12.0%
Project W	1.2 million	11.5
Project X	1.2 million	11.0
Project Y	1.2 million	10.5
Project Z	1.0 million	10.0

The company has a target capital structure that consists of 50 percent debt and 50 percent equity. Its after-tax cost of debt is 8 percent, its cost of equity is estimated to be 13.5 percent, and its net income is \$2.5 million. If the company follows a residual dividend policy, what will be its payout ratio?

- a. 12%
- b. 32%**
- c. 54%
- d. 66%
- e. 100%

160. Your company has decided that its capital budget during the coming year will be \$20 million. Its optimal capital structure is 60 percent equity and 40 percent debt. Its earnings before interest and taxes (EBIT) are projected to be \$34.667 million for the year. The company has \$200 million of assets; its average interest rate on outstanding debt is 10 percent; and its tax rate is 40 percent. If the company follows the residual dividend policy and maintains the same capital structure, what will its dividend payout ratio be?

- a. 15%
- b. 20%
- c. 25%**
- d. 30%
- e. 35%

161. Brock Brothers wants to maintain its capital structure that consists of 30 percent debt and 70 percent equity. The company forecasts that its net income this year will be \$1,000,000. The company follows a residual dividend policy and anticipates a dividend payout ratio of 40 percent. What is the size of the company's capital budget?

- a. \$ 600,000
- b. \$ 857,143**
- c. \$1,000,000
- d. \$1,428,571
- e. \$2,000,000

162. The following facts apply to your company:

Target capital structure:	50% debt; 50% equity.
EBIT:	\$200 million.
Assets:	\$500 million.
Tax rate:	40%.
Cost of new and old debt:	8%.

Based on the residual dividend policy, the payout ratio is 60 percent. How large (in millions of dollars) will the capital budget be?

- a. \$ 43.2
- b. \$ 50.0
- c. \$ 64.8
- d. \$ 86.4**
- e. \$108.0

163. Makeover Inc. believes that at its current stock price of \$16.00 the firm is undervalued in the market. Makeover plans to repurchase 2.4 million of its 20 million shares outstanding. The firm's managers expect that they can repurchase the entire 2.4 million shares at the expected equilibrium price after repurchase. The firm's current earnings are \$44 million. If management's assumptions hold, what is the expected per-share market price after repurchase?

- a. \$16.00
- b. \$17.26
- c. \$18.18**
- d. \$20.00
- e. \$24.4

164. Which of the following statements is FALSE?

- a) Positive covariance means that asset returns move together.
- b) A zero covariance implies there is no relationship between two variables.
- c) If two assets have perfect negative correlation, it is impossible to reduce the portfolio's overall variance.**
- d) The covariance is equal to the correlation coefficient times the standard deviation of the first stock times the standard deviation of the second stock.

165. What is the portfolio's standard deviation if you put 25% of your money into stock A which has a standard deviation of returns of 15% and the rest into stock B which has a standard deviation of returns of 10%? The correlation coefficient between the returns of the two stocks is +.75.

- a) 11.25%
- b) 10.60%**
- c) 12.40%
- d) 15.00%

166. What is the standard deviation of the portfolio in the question above, if the correlation coefficient is now -.75?

- a) 2.8%.
- b) 4.2%.
- c) 5.3%.**
- d) 10.6%.

167. Suppose an investor has two assets whose standard deviation of returns are 30% and 40%. The assets are perfectly negatively correlated. What asset weights will eliminate all portfolio risk?
- a) 50% and 50%.
 - b) 30% and 40%.
 - c) **57% and 43%.**
 - d) Not enough information to answer the question.
168. Which of the following statements is FALSE?
- a) Potential benefits from diversification arise when correlation is less than +1.
 - b) **If the correlation coefficient were 0, a zero variance portfolio could be constructed.**
 - c) If the correlation coefficient were -1, a zero variance portfolio could be constructed.
 - d) The lower the correlation coefficient the greater the potential benefits from diversification.
169. The correlation between assets D and E is +.50. Asset D has a standard deviation of 40% and asset E has a standard deviation of 60%. What is the standard deviation of the portfolio if 40% is invested in asset D?
- a) 21%
 - b) **46%**
 - c) 52%
 - d) 60%
170. An investor puts 60% of his money into T -Bills that earn 5% and 40% into risky stocks which are expected to earn 10% and have a standard deviation of 15%. What is the expected return and the standard deviation of the portfolio?
- a) 4%; 3%.
 - b) 5%; 7%.
 - c) 6%; 7%.
 - d) **7%; 6%.**

171. A measure of how well the returns of two risky assets move together is the:
- a) Range.
 - b) Covariance.**
 - c) Semi-variance.
 - d) Standard deviation.
172. A portfolio manager adds a new stock to a portfolio. The stock has the same standard deviation as the existing portfolio but a correlation coefficient with the existing portfolio that is less than + 1. What effect will adding the new stock have on the standard deviation of the revised portfolio?
- a) The standard deviation will increase
 - b) The standard deviation will decrease**
 - c) The standard deviation will be unaffected
 - d) Impossible to say without more information
173. An investor currently owns Brown Corp. stock and is thinking of adding either James Corp. or Beta Corp. stock to his holdings. All three stocks offer the same expected return and same total risk. The correlation of returns between Brown stock and James stock is - 0.50 and the correlation between Brown stock and Beta stock is +.50. The risk of the portfolio would:
- a) Decline more if you bought Beta Co.
 - b) Decline more if you bought James Co.**
 - c) Decrease if you bought James Co. but increase if you bought Beta Co.
174. Which one of the following portfolios falls below the Markowitz efficient frontier?

PORTFOLIO	EXPECTED RETURN	PORTFOLIO SD
A	10%	14%
B	9%	26%
C	12%	22%
D	15%	30%

175. In year one, Stock A's return was 10% and stock B's return was 15%. In year 2, stock A's return was 6% and stock B's return was 9%. What is the covariance of returns between stocks A and B?

- a) 2.
- b) 3.
- c) **6.**
- d) 12.

176. Stock A's standard deviation of returns is 50% and Stock B's standard deviation of returns is 30%. Stock A and Stock B's returns are perfectly positively correlated. According to portfolio theory, how much should be invested in each stock to minimize the portfolio's standard deviation?

- a) 100% in Stock A.
- b) **100% in Stock B.**
- c) 30% in Stock A and 70% in Stock B.
- d) 50% in Stock A and 50% in Stock B.

177. The standard deviation of returns is 30% for Stock A and 20% for Stock B. The covariance between the returns of A and B is 0.006. The correlation of returns between stocks A and B is:

- a) **0.10.**
- b) 0.20.
- c) 0.30.
- d) 0.35.

178. An investor put 60% of his money into a risky asset offering a 10% return with a standard deviation of returns of 8% and the balance in a risk-free asset offering 5%. What is the expected return and standard deviation of this portfolio?

- a) 6.0% 6.8%
- b) 7.5% 80%
- c) **8.0% 4.8%**

d) 10.0% 6.6%

179. As you increase the number of stocks in a portfolio, the systematic risk will:

- a) **Remain constant.**
- b) Increase at a decreasing rate.
- c) Decrease at a decreasing rate.
- d) Decrease at an increasing rate.

180. Total risk equals:

- a) Unique plus diversifiable risk.
- b) Market plus non-diversifiable risk.
- c) **Systematic plus unsystematic risk.**
- d) Systematic plus non-diversifiable risk.

181. According to the systematic risk principle, the market will compensate investors for bearing:

- a) **Systematic risk.**
- b) Unsystematic risk.
- c) Total Risk
- d) Diversifiable risk

182. What would happen to the SML if the risk-free rate remained constant while the market rate of return increased?

- a) The SML would exhibit a parallel shift upward.
- b) The SML would exhibit a parallel shift downward.
- c) The vertical intercept would remain the same, but the SML would swivel down
- d) **The vertical intercept would remain the same, but the SML would swivel up**

183. What is the required rate of return for a stock with a beta of 1.2, when the risk-free rate is 6% and the expected market return is 12%?

- a) 6.0%.

- b) 7.2%.
- c) 12.0%.
- d) 13.2.%**

184. What is the required rate of return for a stock with a beta of .70, when the risk-free rate is 7% and the market is offering 14%?

- a) 11.9%.**
- b) 14.0%.
- c) 14.9%.
- d) 16.8%.

185. The risk-free rate is 6% and the expected market return is 15%. An investor sees a stock with a beta of 1.20 selling for \$25. The investor thinks that the stock will sell for \$31 at year end. The stock is _____ so the investor should _____ :

- a) overpriced, buy it
- b) overpriced, short (sell) it
- c) underpriced, buy it**
- d) underpriced, short (sell) it

186. The expected market return is 15% next year and the risk-free rate is 7%. If the expected return on a stock is 17.40%, what is the beta of the stock?

- a) 1.40
- b) 1.74
- c) 1.71.
- d) 1.30**

187. The covariance of the market's returns with a stock's returns is .005. The standard deviation of the market's returns is 5%. What is the stock's beta?

- a) 0.1.
- b) 1.0.
- c) 1.5.

d) 2.0.

188. The covariance of the market's returns with the stock's returns is .008. The standard deviation of the market's returns is 8% and the standard deviation of the stock's returns is 11%. What is the correlation coefficient between the stock and market's returns?

- a) +0.50
- b) + 0.91**
- c) + 1
- d) +1.25

189. Which of the following statements are TRUE?

- I. The beta of a stock is primarily determined by its correlation with the market
- II. Securities that fall above the SML are undervalued
- III. Securities that fall below the SML are undervalued
- IV. Securities that fall on the SML have no intrinsic value to the investor.
- V. The risk-free rate defines where the SML intersects the Y axis.

- a) I and III only
- b) I, III and V only
- c) I, II, and V only**
- d) I, II, IV, and V only

